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Tax Issues for Distressed Corporations

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The restrictions on social and commercial activity necessitated by the COVID-19 pandemic have resulted in unprecedented economic strain. Although governments have enacted equally unprecedented fiscal and monetary stimuli, businesses will be affected and some will need to restructure debts or take other actions to weather this crisis. The following is an overview of key tax issues that may be relevant to a business that is considering a debt restructuring, and certain other tax issues with increased prominence in light of the COVID-19 economic impact.

Debt Forgiveness Rules

The *Income Tax Act* (Canada) (ITA) contains a complex and comprehensive set of rules dealing with the treatment of debt forgiveness. The debt forgiveness rules generally apply when there is a settlement or extinguishment of a debt and the fair market value of the consideration for the settlement or extinguishment is less than the amount of the debt. While different rules apply in a foreclosure situation, generally the debt forgiveness rules treat the difference between the amount of debt that is settled and the amount paid to settle it as a forgiven amount subject to rules outlined below. These rules also apply to so-called debt-parking transactions in which a related party acquires debt for less than 80% of the amount of the debt, but does not cancel the debt. **Importantly, an amendment to the existing terms of a debt or a consent to defer but not cancel payment obligations should not result in debt forgiveness.**

An important exception to the rules governing the settlement of debt for below-market consideration exists when debt-for-debt refinancing occurs. In a debt-for-debt refinancing, it is the principal amount of the new debt, not its fair market value, that is used to measure whether there has been a forgiveness. This rule facilitates a replacement of short-term debt with long-term debt, or other debt-for-debt restructurings without debt forgiveness consequences. In contrast, in a debt-for-share conversion, the fair market value of the shares issued to settle the debt is generally used to measure the debt forgiveness consequences.

In limited circumstances, a Canadian corporation may issue a special class of distress preferred shares in satisfaction of a debt. For purposes of the debt forgiveness rules, the paid-up capital of any distress preferred shares issued in satisfaction of the debt will be deemed to a payment for the principal amount, as opposed to the fair market value of the shares. A Canadian lender may be entitled to receive dividends on distress preferred shares on a tax free basis, and it may be possible to refinance higher interest loans from Canadian lenders with distress preferred shares at a reduced cost.

If there is a debt forgiveness, the forgiven amount is applied automatically to reduce the debtor's loss carryforwards (with non-capital losses being ground down before net capital losses are reduced). To the extent that a forgiven amount remains after eliminating the loss carryforward balances, the debtor may apply the debt forgiveness on an elective basis to reduce undepreciated capital cost and resource expenditures. If these pools have been exhausted, the forgiven amount can be applied to reduce the adjusted cost base of certain capital property or reduce current year capital losses. If a forgiven amount remains after any elective amounts have been applied, 50% of the remaining forgiven amount is included in income (Forgiven Included Amount). The rules that apply to a debtor that is a partnership are different in a number of respects.

A number of rules can minimize the impact of the Forgiven Included Amount. Businesses can elect to allow the Forgiven Included Amount to be transferred to a related person and used to reduce its tax attributes in order to avoid income inclusion. They can also claim a reserve to bring the Forgiven Included Amount into income over five years. Lastly, subject to certain restrictions, insolvent companies are generally not required to include the Forgiven Included Amount in income.

In addition to the debt forgiveness rules, the ITA provides that an expense deducted on an accrual basis in a year that is owing to a non-arm's length person that remains unpaid after the end of the third year is added back to income in the third year. Similarly, any remuneration that is accrued at the end of the year and not paid within 180 days after the end of the year shall be deemed not to be an expense in the year the amount was accrued, and will instead be deductible when paid.

Government Assistance Payments

Government assistance payments, including the Canada Emergency Wage Subsidy and the forgivable portion of the Canada Emergency Business Account, are generally required to be included in income in the year they are received. However, the income inclusion can be avoided if a taxpayer elects to reduce the amount of a related expense incurred in that and certain other taxation years.

Extension of Due Dates for Income Tax Filings and Payments

As an administrative matter, in light of the adverse economic consequences of the COVID-19 pandemic, the Canada Revenue Agency (CRA) has extended the due dates for certain income tax filings and payments. **Note that while the payment due dates for most income tax balances have been deferred, employee source deductions and withholding tax remittances are due in the ordinary course. For a full description of the tax filings and payments that are eligible for administrative relief, see our bulletin Canadian Tax and Other Measures Implemented in Response to COVID-19 Pandemic.**

Non-Resident Withholding Tax

The changing circumstances of a distressed corporation could result in payments made in the ordinary course of business, such as rent, interest or royalties, becoming subject to Canadian withholding tax under Part XIII of the ITA.

For example, if a Canadian borrower defaults under a credit agreement, and a foreign lender realizes on collateral provided for the loan that consists of shares of the borrower, future interest payments made by the borrower to the lender may result in the application of Canadian withholding tax. First, such payments may be subject to Canadian withholding tax on the basis that the borrower and lender are not dealing at arm's length because the lender, on realization of the collateral, owns enough shares in the borrower corporation that the parties are considered related or otherwise not dealing at arm's length on a factual basis.[1] The realization on the shares of the borrower may also result in an acquisition of control and loss restriction event that can restrict the ability to use loss carryforwards.

Second, following a realization of collateral that includes shares of the borrower, the foreign lender may obtain a sufficient number of shares in the borrower to be considered a "specified non-resident shareholder" for the purposes of the "thin capitalization" rules, which may effectively convert the interest to a dividend payment, including for withholding tax purposes. If a payment of interest is subject to withholding tax in these circumstances, it is important to review the underlying credit agreement to determine whether a gross-up for taxes is required or if the borrower may pay the interest net of withholding taxes.

Other ordinary course payments such as rent and royalties may become subject to Canadian withholding tax when an initial Canadian recipient of such payments assigns its rights under the applicable lease or royalty agreement to a foreign assignee, such as a foreign distressed investment fund. Moreover, under such changing circumstances, a person who pays a non-resident of Canada a fee, commission or other amount in respect of services rendered in Canada is required to withhold 15% from such payments under Regulation 105 of the *Income Tax Regulations* (Canada). Consequently, a payor in Canada who is making payments to a non-resident assignee should exercise caution in determining whether there is a withholding requirement on the basis that the payments are made in respect of services rendered in Canada.

Considerations for Creditors

A holder of a debt that was forgiven generally will be entitled to claim a loss in respect of the disposition of the debt, which will be an income loss or a capital loss depending on the treatment of the debt to the creditor. Where the creditor is affiliated with the debtor, and in certain other instances, one or more rules may deny or defer the realization of the loss.

When a creditor seizes property from a debtor or third party (such as a guarantor) in respect of a debt, the creditor will generally be deemed to have disposed of the debt at its adjusted cost base and to have acquired the seized property with a cost equal to the cost of the debt. Consequently, the creditor will generally not realize a gain or loss as a consequence of the seizure of property until it disposes of the property. A holder of a debt obligation is generally required to include in its income any amount received or receivable by the holder on account of interest to the extent that the interest was not included in computing the holder's income for a preceding taxation year.

If a creditor agrees to waive or defer payments of interest owing by a distressed borrower, the CRA has taken the position that a waiver of interest that has no legal effect, such that the creditor retains a legal right to receive the interest, does not eliminate the requirement to include the waived interest in the creditor's income under the interest income inclusion provisions. However, when the waiver is legally binding on both the creditor and the debtor, the CRA has acknowledged that the creditor would not have a legal right to receive the interest for the relevant period of the waiver and, therefore, the interest should not be considered receivable, received or accrued and should not be required to be included in income.

When an amount of interest is deferred from a particular taxation period to another period, the underlying obligation may be considered a "prescribed debt obligation" resulting in a deemed interest accrual for the creditor for the period during which the interest is deferred.

Therefore, a creditor that intends to permanently waive an amount of interest should structure the arrangement with the borrower to make it legally binding. The waiver may be considered legally binding when the parties enter into an amending agreement. Caution should be exercised to avoid fundamentally altering the debt obligation such that the initial obligation is considered disposed of and a new obligation is considered to have come into existence (i.e., a novation), as this may give rise to additional unanticipated tax consequences to the parties. In contrast, when the interest will be deferred to a subsequent taxation period, the creditor may nevertheless be required to include in its income deemed accrued interest in respect of the deferred amounts.

Certain creditors that are financial institutions (for purposes of the "mark-to-market" rules in the ITA) or taxpayers whose ordinary business includes the lending of money may claim a reserve in respect of doubtful or impaired debts. A creditor that claims a reserve in respect of an impaired debt obligation, in general, is not required to include interest income in respect of the obligation during the period that the obligation is impaired. Taxpayers that are not financial institutions should be entitled to a reserve for doubtful amounts, but in the case of debt, the reserve can be claimed only in respect of interest and not principal.

Consent Payments to Non-Residents

Consent payments may arise in a number of contexts for distressed companies seeking to restructure certain commercial arrangements. The Federal Court of Appeal's recent decision in *Pangaea* found that a letter agreement under which a consent payment was made to a non-resident shareholder to facilitate the sale of a company was in respect of a restrictive covenant for purposes of the ITA and thus subject to withholding tax. The payment was made in consideration for that shareholder's (legally necessary) consent to the sale. The Court concluded that the letter agreement was captured by the relatively broad wording of the definition of "restrictive covenant," which extends, in general terms, to any agreement, undertaking or right intended to affect, in any way whatever, the acquisition or provision of property or services by the taxpayer.

The definition of "restrictive covenant" in the ITA has traditionally been considered to apply to non-compete and similar agreements (although due to the broad wording of the definition, there has been some uncertainty as to its scope). The decision in *Pangaea* establishes a broad scope of agreements, undertakings or rights that could potentially be treated as restrictive covenants for tax purposes. **Distressed companies making payments to non-residents in the context of a restructuring or refinancing should be cognizant of the potential characterization of such payments as restrictive covenants, particularly when the underlying agreement, undertaking or right could be considered to affect the acquisition or provision of property or services by the payor. When such a payment is made to a non-resident, the requirement to withhold and remit withholding tax and the potential negotiation of a gross-up for such amounts should be taken into account.**

Deemed Trust for Amounts Withheld or Collected

All amounts required to be deducted or withheld under the ITA, including employee source deductions and amounts withheld from payments to non-residents, are deemed to be held in trust for Her Majesty the Queen and payable as and when required under the ITA. In general, the right of the CRA (on behalf of Her Majesty) to collect such amounts ranks in priority to security interests of all other secured creditors (including in the context of bankruptcy proceedings governed by the *Bankruptcy and Insolvency Act* (BIA)) and is deemed to (i) form no part of the estate or property of the party that withheld the amounts, and (ii) be beneficially owned by Her Majesty the Queen. The deemed trust has been described as giving the CRA a "super priority" over source deductions and other withheld amounts. A similar deemed trust arises in respect of goods and services and/or harmonized sales taxes (GST/HST) that have been collected and not remitted, except in the context of bankruptcy proceedings under the BIA or insolvency proceedings under the *Companies' Creditors Arrangement Act* (Canada).

Director Liability

The CRA has announced that the remittance due date for GST/HST owing on or after March 27, 2020, and before June 1, 2020 is postponed until the end of June 2020. There is no similar extension for source deductions or withholding taxes. Corporate directors should be mindful that both the ITA and the *Excise Tax Act* (Canada) (ETA) impose liability on directors in respect of unremitted withheld or collected amounts, such as source deductions from employee salaries in the income tax context and GST/HST collected under the ETA in the goods and services tax context, together with any related interest and penalties thereon.

A due diligence defence is available to shield directors from liability under the ITA and ETA in respect of failure to remit the relevant amounts. The due diligence defence applies when the director exercised the degree of care, diligence and skill to prevent the failure that a reasonably prudent person would exercise in comparable circumstances. Moreover, the related limitation periods in the ITA and the ETA are restricted to the two-year period after the director last ceased to be a director of the particular corporation.

To mitigate personal liability, directors of distressed corporations should ensure that robust systems are in place for the accurate and timely deduction and remittance of statutory source deductions for income tax purposes and the collection and remittance of GST/HST. **When a corporation has deferred the remittance of GST/HST until June, the directors should take steps to have the corporation remit any deferred amounts by June 30, 2020. Otherwise, the CRA may take the position that the corporate directors are liable for the unremitted amounts.**

In addition to liability under the ITA and ETA, directors may be liable for unremitted withholdings in respect of Canada Pension Plan and employment insurance.

[1] The Canada-United States Treaty may avoid this result for qualifying U.S. creditors.

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